No. 91-7804

In The

Supreme Court of the United States

October Term, 1992

SHELDON B. BUFFERD,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

BRIEF FOR PETITIONER

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QUESTION PRESENTED

Whether the statute of limitations bars adjustments to Petitioner's income tax return with respect to items arising from an S corporation's income tax return?

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OPINIONS BELOW

The opinion of the Court of Appeals [Joint Appendix (hereinafter "J.A.") 66] is reported at 952 F.2d 675 (2d Cir. 1992). The memorandum opinion of the Tax Court (J.A. 62) is unofficially reported at 61 T.C.M. (CCH) 2410 (1991).

JURISDICTION

The judgment of the Court of Appeals was entered on January 3, 1992. The petition for writ of certiorari was filed on March 31, 1992, and was granted on June 22, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. section 1254(1).

STATUTORY PROVISIONS INVOLVED

Internal Revenue Code section 6501(a) (1979):

> (a) General rule.-Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) . . . and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

Internal Revenue Code section 6037 (1979):

> Every electing small business corporation (as defined in section 1371(a)(2)) shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, the names and addresses of all persons owning stock in the corporation at any time during the taxable year, the number of shares of stock owned by each shareholder at all times during the taxable year, the amount of money and other property distributed by the corporation during the taxable year to each shareholder, the date of each such distribution, and such other information, for the purpose of carrying out the provisions of subchapter S of chapter 1, as the Secretary or his delegate may

by forms and regulations prescribe. Any return filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as a return filed by the corporation under section 6012.

Internal Revenue Code section 6012(a)(2) (1979):

(a) General Rule.-Returns with respect to income taxes under subtitle A shall be made by the following: . . .

(2) Every corporation subject to taxation under subtitle A; . . . .

Internal Revenue Code section 6031 (1979):

Every partnership (as defined in section 761(a)) shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, and such other information for the purpose of carrying out the provisions of subtitle A as the Secretary may by forms and regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual.

Internal Revenue Code section 1373(b) (1979):

(b) Amount included in gross income.-Each person who is a shareholder of an electing small business corporation on the last day of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for the corporation's taxable year. For purposes of this chapter, the amount so included shall be treated as an amount distributed as a dividend on the last day of the taxable year of the corporation.

Internal Revenue Code section 1378(a) (1979):

(a) General rule.-If for a taxable year of an electing small business corporation –

(1) the net capital gain of such corporation exceeds \$25,000, and exceeds 50 percent of its taxable income for such year, and

(2) the taxable income of such corporation for such year exceeds \$25,000, there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation.

STATEMENT

In 1979, the tax year at issue, Petitioner[1] was a shareholder in Compo Financial Services, Inc. (hereinafter "Compo"), which qualified as an electing small business corporation (hereinafter "S corporation") under subchapter S of the Internal Revenue Code (hereinafter "Code") 26 U.S.C. section 1371 *et seq.*[2] J.A. 37. Compo held an interest in a partnership, Printer's Associates. J.A. 40.

On February 1, 1980, Compo filed a timely United States Small Business Corporation Income Tax Return (hereinafter "Form 1120S") for the period ended November 30, 1979. J.A. 38. On its corporate return, Compo claimed its share, as a partner, of the Printer's Associates' losses and tax credits. J.A. 37-41. Petitioner timely filed his federal income tax return for 1979 on April 15, 1980. J.A. 19. Petitioner, as a shareholder in Compo, included on his 1979 income tax return a pro rata portion of the losses and tax credits reported by Compo on its income tax return for the fiscal year ended November 30, 1979. J.A. 26 and 29.

[1] Petitioner filed a joint return for 1979 with Phyllis Bufferd, to whom Petitioner was then married. Although Phyllis Bufferd, as well as Petitioner, were parties to the proceedings below, Phyllis Bufferd has entered into a settlement with the Internal Revenue Service. J.A. 13, which was accepted by the Tax Court, J.A. 58, and is no longer a party to this case.

[2] Unless otherwise indicated, all section references in this brief are to the Internal Revenue Code of 1954, 26 U.S.C. §1 *et. seq.*, as in effect for 1979, the year at issue.

The Commissioner normally must assess tax deficiencies within three years after the filing of a return. Section 6501(a). In the past, the Internal Revenue Service (hereinafter "Service") has sought and obtained an extension of this period from S corporations. In this case, however, the government did not seek an extension for the fiscal year ending November 30, 1979. J.A. 14. It did seek and obtain an extension from Compo for the fiscal year ending November 30, 1980, and from Petitioner for his tax year 1979. J.A. 53. In March 1983, Petitioner and Respondent entered into a restricted "Special Consent to Extend the Time to Assess Tax" (hereinafter "Form 872-A"), extending the period for assessing tax due on Petitioner's individual 1979 income tax return until ninety days after such time as Petitioner or Respondent would choose to revoke the extension. The Special Consent was limited by its terms to deficiencies arising from items relating to his interest in a partnership or an organization treated by Petitioner as a partnership on his income tax return. J.A. 55.

In 1987, Respondent determined that the activities of Printer's Associates had not given rise to deductible losses or tax credits. Although more than three years had elapsed since Compo had filed its Form 1120S and Respondent had not obtained an extension of the regular limitations period from Compo, Respondent disallowed most of the losses and all of the tax credits that Compo had reported in its capacity as a partner in Printer's Associates. J.A. 14. On December 15, 1987, pursuant to this adjustment, Respondent issued a Statutory Notice of Deficiency with respect to Petitioner's 1979 income tax return disallowing the losses and tax credits that Petitioner had reported as a shareholder in Compo based on the losses and tax credits that had been reported on Compo's income tax return.

On February 25, 1988, Petitioner filed a Petition in the United States Tax Court (hereinafter "Tax Court") challenging the disallowance of the S corporation items. J.A. 8. Petitioner sought a determination that, to the extent the deficiency resulted from adjustments made to the losses and tax credits that Compo had reported on its S corporation income tax return, Respondent's Statutory Notice of Deficiency was time-barred by the statute of limitations.

On March 19, 1990, the case was submitted on a Joint Motion to Submit Case Under Rule 122. All facts were agreed to by both parties in a Stipulation of Facts (J.A. 12-16), and a Second Stipulation of Facts with Exhibits 1A through 7G attached (J.A. 17). On May 14, 1991, the Tax Court entered a decision, T.C. Memo. 1991-170, reported unofficially at 61 T.C.M. (CCH) 2410 (1991).

In its memorandum opinion, the Tax Court noted that it had held recently in *Kelley v. Commissioner,* 52 T.C.M. 313 (CCH) (1986), that the period of limitations for assessing a deficiency resulting from the disallowance of a loss or tax credit from a subchapter S corporation was measured by reference to the shareholder's, and not the corporation's, income tax return. J.A. 57. The Tax Court acknowledged that the Court of Appeals for the Ninth Circuit had reversed its opinion in Kelley. (*Kelley v. Commissioner,* 877 F.2d 756 (1989)). J.A. 61. Nonetheless, the Tax Court adhered to its original position and adopted as its opinion in this case its opinion in *Fehlhaber v. Commissioner,* 94 T.C. 863 (1990). J.A. 57.

Petitioner appealed to the United States Court of Appeals for the Second Circuit which entered a judgment on January 3, 1992, in favor of the Respondent. The Second Circuit viewed the issue here as governed by its previous decision in *Siben v. Commissioner,* 930 F.2d 1034 (1991), *cert. denied,* ___ U.S. ___, 112 S.Ct. 429 (1991), in which the court had determined that a deficiency assessment against a partner, related to an item reported by a partnership, was not barred by any limitations period applicable to the partnership's return. J.A. 70. The court concluded that its holding in *Siben* applied to S corporations as well as partnerships. The court rejected Petitioner's argument that in enacting 6037(a), Congress had established rules for S corporation income tax returns that differed from those applicable to partnerships. J.A. 72.

Petitioner submitted his petition for writ of certiorari to this Court on March 31, 1992, which this Court granted on June 22, 1992, due, *inter alia,* to a split among the circuits.[3]

SUMMARY OF ARGUMENT

This case requires this Court to interpret the clear and unambiguous language of three interdependent sections of the Code: sections 6012(a)(2), 6501(a), and 6037(a).

Section 6012 sets forth the general requirement for filing a "return." Section 6012(a)(1), for example, requires returns from individuals earning more than certain minimum amounts of income during the year, and section 6012(a)(2) requires returns from "[e]very corporation subject to taxation under subtitle A." Section 6501(a) of the Code contains the basic rule governing limitations on assessments. It provides generally that the government may assess a deficiency "within three years after the return was filed." The statute thus places considerable emphasis on the identification of the "return" in section 6501(a).

The first sentence of section 6037(a) requires every S corporation to file annually an income tax return. The second sentence of section 6037(a) provides that this return shall be treated as a return required by section 6012 for purposes of the statute of limitations. The second sentence of section 6037(a) makes the S corporation's income tax return the "return" that begins the running of the period of limitations under section 6501(a). Therefore, it is only within the three-year period set forth in section 6501(a) that the Service or the S corporation may adjust items of income, deduction, or tax credit with respect to the S corporation's income tax return.

The Second Circuit concluded that it is the filing of the income tax return of the S corporation's shareholder rather

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[3] The Second Circuit's opinion conflicts with the opinion of the Court of Appeals for the Ninth Circuit in *Kelley v. Commissioner,* 877 F.2d 756 (1989). The Second Circuit's opinion was followed by the Eleventh Circuit in *Fehlhaber v. Commissioner,* 954 F.2d 653 (1992), and the Fifth Circuit in *Green v. Commissioner,* 963 F.2d 783 (1992).

than the S corporation's income tax return that begins the running of the period of limitations. There is no support for this interpretation in the statutory language or its legislative history. In fact, the interpretation afforded these statutes by the Second Circuit is contrary to the plain language of section 6012(a)(2) and the second sentence of section 6037(a) and renders both these sections mere surplusage.

Congress enacted section 6037 in 1958 at a time when there was no tax to be assessed against an S corporation and the second sentence of section 6037 manifests Congress' intent that, for purposes of the period of limitations, the filing date of the S corporation's income tax return, not the S corporation shareholder's income tax return, begins the running of the period of limitations with respect to S corporation items. The statutory language is unconditional and applies whether or not there is a tax imposed on the S corporation in any taxable year.

When the language of the statute is clear and unambiguous, and affords a cohesive and consistent treatment to the statutory scheme, the function of the court is to interpret the statute in accordance with its terms. The Second Circuit did not interpret the statute in accordance with its terms and, effectively, repeals section 6012(a)(2) and the second sentence of section 6037(a).

The Second Circuit ignored the plain meaning of these three Code provisions and turned to the legislative history. It misconstrued an example in the Committee Report promulgated in 1958 to accompany newly-enacted section 6037(a). The Second Circuit's analysis allowed the example to become the entire rule. Based upon this misinterpretation, the Second Circuit concluded that the return referred to in section 6501(a) is the income tax return of the shareholder of an S corporation because it is the only return upon which a tax can be assessed.

The language of the Code as well as its legislative history clearly provide that the date of the filing of the S corporation's income tax return is the beginning date for determining the limitations period for adjusting both the S corporation's

income tax return and the S corporation shareholder's income tax return, with respect to S corporation items of income,[3] deduction, or credit. This Court must reverse the decision of the Second Circuit.

I

THE STATUTE OF LIMITATIONS BARS ADJUSTMENTS TO PETITIONER'S INCOME TAX RETURN WITH RESPECT TO ITEMS ARISING FROM AN S CORPORATION'S INCOME TAX RETURN.

A. PETITIONER'S AGREEMENT TO EXTEND THE PERIOD OF LIMITATIONS DID NOT INCLUDE S CORPORATION ITEMS.

Petitioner's agreement to extend the statute of limitations for 1979 was restricted by its terms to items arising from his ownership of an interest in a partnership or any organization treated by him as a partnership. J.A. 55. The Form 872-A executed by Petitioner and Respondent extends the normal three-year statute of limitations only with respect to the Petitioner's tax basis in, and distributive share, gain, or loss from, such entities. It does not cover items related to any other type of entity.[4] Compo was an S corporation and Petitioner treated it as such on his tax return. J.A. 32. Because Compo was not a partnership or an organization treated by Petitioner as a partnership, Form 872-A did not extend the period of limitations with respect to items arising from Petitioner's interest in Compo. *See, e.g., Goldberg v. Commissioner,* 63 T.C.M. 2168 (CCH) (1992); *Bauer v. Commissioner,* 63 T.C.M. 2921 (CCH) (1992). *Compare, Press v. Commissioner,* 52 T.C.M. 285 (CCH) (1986).

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[4] The statute of limitations has always been an issue in this case. The legal effect of Form 872-A is within the scope of both the affirmative defense of the statute of limitations properly pled by the Petitioner at the Tax Court and the questions presented to both the Second Circuit and this Court.

B. SECTIONS 6501(a), 6012(a)(2), AND 6037(a) OF THE INTERNAL REVENUE CODE REQUIRE THE CONCLUSION THAT THE FILING OF AN S CORPORATION'S INCOME TAX RETURN BEGINS THE PERIOD OF LIMITATIONS WITH RESPECT TO S CORPORATION ITEMS.

This case concerns the confluence of three sections of the Code: sections 6501(a), 6012(a)(2), and 6037(a).

Section 6501(a) provides a three-year limitations period from the date of filing a return for the Service to adjust items contained in the return and to assess any tax imposed by the Code with respect to that return.[5] In relevant portion, section 6501(a) provides that "the amount of any tax imposed by this title shall be assessed within three years after *the return* was filed . . . " (emphasis added).

Section 6012 requires certain persons[6] to file tax returns. Section 6012(a)(2) provides that "[e]very corporation subject to taxation under subtitle A" shall file a tax return. Section 6012(a)(2) is the only paragraph of section 6012 that requires a corporation to file a tax return. That paragraph does not distinguish between S and C corporations.[7]

The first sentence of section 6037(a) requires that "[e]very electing small business corporation . . . shall make a return for each taxable year . . . " and states what the S corporation must include in its income tax return. The second

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[5] Prior to 1966, S corporations were not taxable entities. Nevertheless, since enactment of subchapter S in 1958, section 6037(a) has required all S corporations to file annual income tax returns.

[6] Section 7701(a)(1) defines persons for purposes of the Code to include corporations.

[7] Corporations are taxed under two separate subchapters of the Code. Most corporations are taxed under subchapter C of the Code and are referred to as "C corporations." Subchapter S sets forth rules that permit certain corporations referred to as "S corporations" to be taxed in a special manner. A corporation must elect to be taxed under subchapter S. Prior to substantial changes effected by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669, corporations electing to be taxed under subchapter S were referred to as subchapter S corporations. After the 1982 Revision Act changes, such corporations are now referred to as S corporations. For convenience, this brief uses the phrase "S corporations" throughout.

sentence of section 6037(a) provides that "*[a]ny return* filed pursuant to this section *shall*, for purposes of chapter 66 (relating to limitations), *be treated as a return filed by the corporation under section 6012*" (emphasis added)[8].

Statutory interpretation begins with an analysis of the statute's language. This Court stated in *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (1989):

> The task of resolving the dispute over the meaning of §506(b) begins where all such inquiries must begin: with the language of the statute itself. . . . In this case it is also where the inquiry should end, for where, as here, the statute's language is plain, "the sole function of the courts is to enforce it according to its terms." *Caminetti v. United States*, 242 U.S. 470, 485 . . . (1917). 489 U.S. at 241.

See also, Cippolone v. Liggett Group, Inc., ___ U.S. ___, 112 S.Ct. 2608, 2625 (1992), citing *FMC Corp. v. Holiday*, ___ U.S. ___, 111 S.Ct. 403, 407 (1990), quoting *Park 'N Fly, Inc. v. Dollar Park and Fly, Inc.*, 469 U.S. 189, 194 (1985); *Toibb v. Radloff*, ___ U.S. ___, 111 S.Ct. 2197, 2200 (1991), quoting *Blum v. Stenson*, 465 U.S. 886, 896 (1984); *Patterson v. Shumate*, ___ U.S. ___, 112 S.Ct. 2242, 2248 (1992), quoting *Toibb v. Radloff*, 111 S.Ct. at 2200, and citing *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. at 247, and *Ex parte Collett*, 337 U.S. 55, 61 (1949).

The language of sections 6501(a), 6012(a)(2), and 6037(a) is clear and unambiguous. These three sections, read together, provide that for the purpose of the statute of limitations, the date an S corporation files its income tax return (Form 1120S) is the beginning date for determining the period of limitations for adjusting items on the S corporation's

[8] Chapter 66 of subtitle F of the Code (sections 6501-6553) provides rules for limitations on assessment and collection of taxes, limitations on credit or refund, mitigation of effect of period of limitations, and periods of limitation in judicial proceedings.

income tax return and assessing any tax as a result of those adjustments.[9]

Section 6501(a) provides a three-year period of time from the date of filing a "return" during which the Service may adjust any items on that filed "return" and assess a tax imposed by the Code with respect to that "return." If, within the period of limitations on that "return," the Service concludes that adjustments should be made to that "return," it may assess a tax imposed by the Code on either (1) the person who filed that "return," or (2) on another related person to the extent that the related person's income tax return is based on that "return" and the period of limitations on the related person's income tax return is also open. Therefore, when an individual taxpayer files his or her return, the Service has three years to examine the return and assess any deficiency. When a corporation files its return, the Service has three years to examine the return and assess any deficiency against the corporation. When corporate items affect the shareholder, the Service still has three years to examine the propriety of the corporation's return and three years to examine the shareholder's treatment of the item on his or her individual return.

Both the corporation and the shareholder may agree to extend the limitations period.[10] If the corporation extends the period, the Service has more time to examine the corporation's income tax return. If the shareholder extends the period, the Service has more time to examine the shareholder's income tax return. If the corporation extends the period but the shareholder does not, no change made at the corporate level will affect the shareholder. If the shareholder extends the period but the corporation does not, no change

[9] As a practical matter, the shareholder is bound by the S corporation's income tax return. A shareholder has available and can report only the information supplied to him or her by the S corporation. That information is communicated by the S corporation in the form of a schedule K-1, a part of the Form 1120S, that the S corporation submits to the shareholder. *See, infra*, IV, pp. 45-6.

[10] Section 6501(c)(4) of the Code permits the Service and the taxpayer to consent in writing to an extension of the period of limitations with respect to income tax returns.

with respect to the treatment of items at the corporate level can be made at the shareholder level because the period for examination and assessment at the corporate level has passed.

While there is no disagreement that this is the result in the case of a C corporation, the Second Circuit treats an S corporation differently by arguing that the S corporation does not always file a "return." In its view, the S corporation files a "return" pursuant to section 6501(a) only in those years when it has a tax to pay. *Bufferd v. Commissioner*, 952 F.2d 675, 678 (2d Cir. 1992).

This Court has stated: "There is of course no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes," and the Court departs from the meaning of the words only when their plain meaning produces "absurd results" or a meaning "plainly at variance with the policy of the legislation as a whole." *United States v. American Trucking Assns., Inc.*, 310 U.S. 534, 543 (1940), citing *Ozawa v. United States*, 260 U.S. 178, 194 (1922).

The plain meaning of these sections produces logical, not absurd results. Moreover, the plain meaning furthers the legislative policies of certainty and finality. Properly read, sections 6501(a), 6012(a)(2), and 6037(a) provide that the "return" referred to in section 6501(a) is the S corporation's income tax return and not the shareholder's income tax return. The Ninth Circuit Court of Appeals viewed these three Code sections as an interdependent matrix, correctly deciding in *Kelley v. Commissioner*, 877 F.2d 756 (1989), that "the IRS may not adjust a shareholder's return based on an adjustment to an S corporation's return when the statute of limitations has run on the S corporation's return." 877 F.2d at 759.

In its opinion below, the Second Circuit stated: "At the heart of this dispute is the meaning of the word 'return' in section 6501(a)." *Bufferd v. Commissioner*, 952 F.2d at 677. Indeed, proper identification of the relevant "return" under section 6501(a) is the key to the resolution of this case. The Second Circuit, however, reads section 6501(a) in a vacuum, and ignores the clear and unambiguous language of both section 6012(a)(2) and the second sentence of section 6037(a)

that together define the term "return" in section 6501(a). Related statutory provisions must be read in their entirety. *Cippolone v. Liggett Group, Inc.*, ___ U.S. ___, 112 S. Ct. 2608, 2627 (1992), quoting *Jarecki v. G.D. Searle and Co.*, 367 U.S. 303 (1961); *see also, Hoffman v. Connecticut Dept. of Income Maintenance*, 492 U.S. 96, 103 (1989), quoting *United States v. Menasche*, 348 U.S. 528, 538-9 (1955).

The "return" referred to in section 6501(a), as required by sections 6037(a) and 6012(a)(2), is always that of the corporation. The Code makes no distinction in this regard between C and S corporations; nor does it make relevant whether a tax is assessed against the S corporation. Therefore, the Service may not make adjustments to items on a C or an S corporation's income tax return more than three years after that return was filed. Nor, consequently, may the Service assess any tax against a C or an S corporation's shareholder with respect to corporate items more than three years after the corporation's income tax return was filed unless the corporation has agreed to an extension of the period for assessment and the return of the shareholder's period of limitations is open.

In contrast to this logical synthesis of sections 6501(a), 6037(a), and 6012(a)(2), the court below proposed a strained explanation of section 6501(a) in relation to section 6012(a)(2) and the second sentence of section 6037(a). *Bufferd v. Commissioner*, 952 F.2d at 677. By reading the term "assessed" in section 6501(a) as inextricably linked to the term "return" in section 6501(a), the Second Circuit concluded that the "return" in section 6501(a) can only be a "return" of a taxpayer upon whom a tax could have been "assessed."

The court below interpreted the clear and unambiguous language of the second sentence of section 6037(a) as conditional. It read this sentence to provide that section 6012(a)(2)

refers to an S corporation's income tax return only in the following two circumstances:

(1) When an S corporation income tax return is filed by an invalidly-elected S corporation,[11] or

(2) When there is a tax imposed at the corporate level on the S corporation.[12]

The Second Circuit concluded that when an S corporation election is valid, and when there is no corporate level tax, the filing by an S corporation of its income tax return does not begin the running of the statute of limitations with respect to S corporation items. When, however, the election is invalid, or when there is a corporate level tax, the filing of the S corporation's income tax return does begin the running of the statute of limitations. As a result of this strained interpretation of the interaction of sections 6501(a), 6037(a), and 6012(a)(2), the Second Circuit concluded that the three-year limitation on the adjustments to a "return" in section 6501 refers sometimes to the S corporation's income tax return and sometimes to the shareholder's income tax return.

In the tax year at issue here, Compo had no income subject to tax. Therefore, the court below concluded that it was the filing of the income tax return of the Petitioner rather than the filing of Compo's income tax return that began the running of the period of limitations. Only by ignoring the interaction of sections 6501(a), 6037(a), and 6012(a)(2), *i.e.*, effectively omitting section 6012(a)(2) and the second sentence of section 6037(a) from application to an S corporation, can this interpretation be suggested. Thus, in *Bufferd*, (as in *Fehlhaber* and *Green*), the lower court's conclusion is without merit. There is no language in these three Code sections that supports the court's omission of two of these three co-equal provisions.

In *Fendell v. Commissioner*, 906 F.2d 362, 364 (8th Cir. 1990), the Eighth Circuit relied on the *Kelley* decision and held that the expiration of the limitations period for auditing

[11] *Bufferd v. Commissioner*, 952 F.2d at 677.

[12] *Id.*

a trust's income tax returns barred adjustment of the amount of distributions claimed on its beneficiaries' individual income tax returns. The *Fendell* court reasoned that the Ninth Circuit *Kelley* case, and similar cases such as *Illinois Masonic Home v. Commissioner*, 93 T.C. 145 (1989), and *Boatmen's First Nat'l Bank v. United States*, 705 F.Supp. 1407 (W.D. Mo. 1988), "embody the principle that in order for the Commissioner to adjust tax liability, he must be able to do so at the source of income . . . or [he] will be prevented from doing so at the point where the income is distributed. . . . " *Fendell*, 906 F.2d at 364.[13]

The position of the Second Circuit appears to be that an S corporation is not the "source" of the income except in a year when the S corporation itself is subject to tax. This is yet another consequence of the court's view that the identity of the "return" in section 6501(a) varies with the annual corporate transactions, producing the uncertainty a limitations period should preclude. Application of the statute of limitations to the corporation must depend on the corporate act of filing a return and not upon whether the S corporation's election is valid or whether there is a tax imposed at the S corporation level.

II

AN S CORPORATION IS A CORPORATION (NOT A PARTNERSHIP) AND IT FILES A CORPORATE INCOME TAX RETURN.

A. AN S CORPORATION IS A CORPORATION AND SHOULD BE TREATED LIKE A C CORPORATION.

The background against which Congress enacted subchapter S[14] shows that in 1958 Congress had in mind a model for S corporations that departed markedly from the simple

[13] The Service has announced its disagreement with the *Fendell* decision and its intent to continue to dispute the issue in other circuits. *Fendell*, AOD, CC-1991-01 (Feb. 11, 1991) and *Kelley*, AOD, CC-1991-08 (Mar. 29, 1991).

[14] Technical Amendments Act of 1958, Pub. L. No. 85-866, §64, 72 Stat. 1606.

"passthrough" regime that was generally applicable to partnerships.

Subchapter S represents Congress' attempt to remedy a dilemma that the tax laws previously had presented for many closely-held corporate businesses. The corporate form of doing business offers many protections to the entrepreneur under state law, most notably by affording the shareholder a large measure of insulation from personal liability for corporate obligations. The use of the corporate form, however, often entails a significant tax cost.

The most important such cost historically involved the Code's treatment of losses. It is not unusual for business ventures, especially in their startup years, to incur losses. If losses are incurred by a corporation, they can be deducted only by the corporation; the shareholder cannot deduct these losses against his or her own income. Because the startup corporation typically has no taxable income and therefore derives no value from a tax deduction, the corporation's loss is, in effect, nondeductible. Thus, use of the corporate form can deny the entrepreneur a deduction for losses that would be available if the entrepreneur conducted business directly.[15]

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[15] Another traditional tax cost of using the corporate form involves the "double taxation" of corporate earnings. The income of a corporation normally is taxed first under the corporate income tax. Then, the corporation's after-tax earnings will be taxed again to the shareholders if the earnings are distributed as dividends. For example, a corporation with income sufficiently high to place it in a top tax bracket might earn an additional $1,000 of taxable income from a particular activity. Under the rate structure applicable in 1979, this income might have been taxed at a corporate rate of 46 percent, leaving the corporation with $540 in after-tax income. *See* Code section 11 (1979). If distributed to the shareholders as a dividend, the $540 could be taxed again at an individual rate as high as 70 percent, leaving the shareholders with just $162. *See* Code section 1 (1979). Overall, the corporation's income would have been taxed at a total rate of well over eighty percent.

In practice, the double taxation of corporate earnings was not a major problem for closely-held corporations prior to 1986, because corporate tax rates historically have been lower than individual rates. Taxpayers often were content to earn income in the corporate form and to incur taxation at a relatively low rate, especially if there was no compelling reason to distribute the after-tax earnings as dividends. In 1986, however, Congress radically revised the rate structure, Pub. L. 99-514, §§101(a) and 601(a), 100 Stat. 2096 and 2249 (1986), and corporate rates today generally are higher than individual rates. *Compare* Code section 1 with Code section 11 as in effect in 1992. For this reason, the use of subchapter S, which avoids both these disadvantages, has gained significantly in popularity since 1986.

Partnerships have been traditionally distinguished from corporations for tax purposes. Unlike corporations, partnerships are not themselves subject to tax. Instead, the income, losses, and tax credits of a partnership generally are deemed earned and incurred directly by the partners according to their interests in the partnership. Thus, a partner can, as a general matter, claim his or her share of tax credits and deduct his or her share of partnership losses against income from other sources. The tax advantages of a partnership, however, were available only at a very substantial nontax cost, because the partnership, at least in its traditional form, offers no state law protection against individual liability.

Serious proposals to modify the tax treatment of closely-held corporations were made at least as early as 1946. *See generally,* James S. Eustice and Joel D. Kuntz, *Federal Income Taxation of S Corporations* (hereinafter "Eustice & Kuntz") Par. 1.02 (1985). A Treasury study of that year proposed treating closely-held corporations as partnerships. Richard B. Goode, *The Postwar Corporation Tax Structure* (Treasury Dept. 1946), *reprinted in part* in Eustice & Kuntz at Appendix B.1. In 1954, the Eisenhower Administration made a similar proposal, under which closely-held corporations could elect partnership treatment. *See,* Eustice & Kuntz at Par. 1.02[2]. The Senate adopted this proposal as part of its version of Congress' massive rewriting of the tax laws in 1954, although the proposal was eliminated in conference and did not become law. H.R. 8300, §1351, 83d Cong., 2d Sess. (1954), 100 Cong. Rec. 9034 (1954), *reprinted in* Eustice & Kuntz at Appendix B.2.[16]

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[16] In 1954, Congress amended the tax law to allow partnerships to elect to be taxed as corporations. Revenue Act of 1954, Pub. L. 83-591, 68A Stat. 1, but repealed this change in 1958. Technical Amendments Act of 1958, Pub. L. 85-866, §63, 72 Stat. 1605. Thus, today, as prior to 1955 and after 1958, partnerships are never taxable entities.

In 1958, Congress inserted into the Code the first version of subchapter S. In enacting subchapter S in 1958, Congress did *not* adopt the prior proposals to tax certain closely-held corporations as if they were partnerships. Instead, as enacted in 1958, subchapter S permitted a corporation, which had no more than ten shareholders and met other requirements,[17] to elect to be taxed under what have been described as "modified corporate rules."[18]

Under the 1958 version of subchapter S, a qualified S corporation[19] was not itself subject to the corporate income tax. Code section 1374. In this respect, the treatment of S corporations was similar to that of partnerships.

In their treatment of the corporation's income, however, the 1958 subchapter S rules differed significantly from the rules applicable to partnerships. Section 1373(b) provided:

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[17] In general, a corporation could enjoy the benefits of subchapter S, under the 1958 version of the statute, if it made an election to be so covered and if it did not –

(1) have more than 10 shareholders;
(2) have as a shareholder a person (other than an estate) who was not an individual;
(3) have a nonresident alien as a shareholder; and
(4) have more than one class of stock.

Code section 1371 (1958). The corporation's subchapter S election could be terminated if the corporation earned more than 80 percent of its gross receipts from outside the United States, or derived more than 20 percent of its gross receipts from such "passive" sources as royalties, rents, dividends, and interest. Code section 1372(e)(4)-(5) (1958). These rules had evolved to some extent by 1979; *e.g.*, the Code in 1979 allowed the subchapter S corporation to have as many as 15 shareholders. Code section 1371 (1979).

[18] *See*, H.R. Rep. No. 826, 97th Cong., 2d Sess. 6 (1982) and S. Rep. No. 640, 97th Cong., 2d Sess. 6 (1982).

[19] A note about terminology is in order. From 1958 until 1982, the Code denominated corporations that were eligible for treatment under subchapter S as "electing small business corporations." Code §1371(b). Such corporations were commonly called "subchapter S corporations." *Cf., e.g.*, Boris I. Bittker & James S. Eustice, ***Federal Income Taxation of Corporations and Shareholders***, Par. 6.02 (3d ed. 1971). In 1982, in connection with a substantial rewriting of subchapter S described below, Congress established the contemporary term "S corporation." Pub. L. No. 97-354, §2, 97th Cong., 2d Sess. (1982), *adding* Code §1361.

> (b) Amount included in gross income. – Each person who is a shareholder of an electing small business corporation on the last day of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for the corporation's taxable year. For purposes of this chapter, the amount so included shall be treated as an amount distributed as a dividend on the last day of the taxable year of the corporation.

The instruction that a pro rata portion of the corporation's income shall be included in the shareholder's gross income only to the extent of the "the amount he would have received as a dividend" represents a wholesale incorporation of a central concept of corporate tax law. Distributions from a corporation are treated as dividends under the corporate tax rules only to the extent they are made "out of [the corporation's] earnings and profits." Code section 316(a) (1979). "Earnings and profits" is, in turn, a measure of a corporation's economic income that has no real analogue outside the corporate tax rules.[20] Congress, in 1958, thus limited an S corporation shareholder's liability for taxation on the corporation's income by the corporation's "earnings and profits," a peculiarly "corporate" measure of income.

Another peculiar consequence of the incorporation into subchapter S of the dividend rules of the corporate tax was

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[20] "Earnings and profits" is among the more confusing concepts in federal taxation. A corporation's earnings and profits generally will differ from its taxable income. Interest on tax exempt bonds, for example, is not included in determining a corporation's taxable income, but is included in determining a corporation's earnings and profits. The prominent role given by the corporate tax rules to earnings and profits has been subject to a great deal of criticism over the years, but it remains central to corporate taxation. *See, e.g.*, Walter E. Blum, ***Repeal of the "Earnings and Profits" Concept***, 22 San Diego L. Rev. 205 (1985).

the general failure of subchapter S to provide for the passthrough of the "character" of the corporation's income. If, for example, a partnership earns interest on tax exempt state or local bonds, the tax exempt character of the interest traditionally has "passed through" to the partners. With the special exception of a rule providing for the passthrough of capital gains characterization,[21] however, income deemed earned by an S corporation's shareholder under the 1958 rules was simply "dividend" income; it did not retain its character as earned by the corporation.[22] This "bottom line" passthrough is directly analogous to the characterizaton of distributions from a C corporation as dividends to the shareholder and quite diferent from the carryover of the character of individual items from a partnership to a partner.

With certain inapplicable exceptions,[23] a C corporation income tax return is subject to a three-year period of limitations under sections 6012(a)(2) and 6501(a) of the Code. The Service may not adjust a C corporation shareholder's income tax return as a result of adjustments to the C corporation's return after the expiration of the corporation's three-year period of limitations. But in the view of the Second Circuit, the rule should be different for an S corporation because an S corporation is not a separate taxable entity. In the lower court's view, adjustments to an S corporation's income tax return always affect a shareholder's income tax return, while adjustments to a C corporation's income tax return never

[21] Code section 1375(a)(1) (1958).

[22] *Cf.* Code section 1373 (1958) ("For purposes of this chapter, the amount . . . included [in the income of the subchapter S shareholder] shall be treated as an amount distributed as a dividend. . . . "). The 1958 legislative history indicates that this "corporate" result was not accidental:

> Generally, [the corporation's] income is treated as ordinary income to the shareholder without the retention of any special characteristics it might have had in the hands of the corporation. This rule has been adopted so that this provision can operate in as simple a manner as possible. Long-term capital gains, however, are an exception to this general rule. S. Rep. No. 1983, 85th Cong., 2d Sess., 1958-3 C.B. at 1009.

[23] *See*, for example, the exceptions to section 6501(a) provided in section 6501(c).

affect a shareholder's income tax return, because a C corporation is a separate taxable entity.

That view is wrong. Adjustments to an S corporation's income tax return may not affect a shareholder's income tax return. For example, adjustments that affect the income tax liability of the S corporation itself will not affect the shareholder's income tax return. Moreover, adjustments to a C corporation's income tax return can affect the income tax return of a shareholder. For example, under sections 301(c), 312(a), and 316(a), a shareholder treats a distribution from a C corporation, depending on the amount of the corporation's earnings and profits, as either a dividend, a return of capital, or a gain from the sale or exchange of property. Because adjustments to a C corporation's income tax return could affect the amount of earnings and profits of the corporation, these adjustments can have an impact on the treatment of a distribution that the corporation's shareholder receives and may have to report on his or her individual income tax return.

The following example illustrates the interaction of the tax rules and the statute of limitations rules for a C corporation:

> X formed C Corporation on July 1, 1978 by transferring $50,000 cash to C Corporation. C Corporation manufactured and sold widgets. For its taxable year, July 1, 1978 to June 30, 1979, C Corporation timely filed a Form 1120 corporate income tax return showing gross income of $120,000 and deductions of $121,000 for a net loss of $1,000.
>
> On April 1, 1979, C Corporation made a $3,000 cash distribution to X. X timely filed his 1979 individual income tax return and did not include the $3,000 in his income, treating it as a return of capital under section 301(c)(2)(A) of the Code.
>
> C Corporation's statute of limitations expired while the Service was timely auditing X's 1979 income tax return. During the audit, while considering the $3,000 distribution, the Service determined that C Corporation had unintentionally, but improperly, deducted $5,000 so that it should have reported $4,000 in income rather than a $1,000 loss.

> As a result, X should have treated the \$3,000 distribution as a dividend to X under section 301(c)(1) of the Code. Because the Service did not obtain an extension of C Corporation's period of limitations, the Service cannot include the \$3,000 in X's income on his 1979 individual income tax return.

The foregoing example demonstrates that adjustments made at the C corporation level may have an immediate impact on the shareholder's income tax return despite the fact that a C corporation and its shareholder are separate taxable entities.

In *Moline Properties Inc. v. Commissioner,* 319 U.S. 436 (1943), this Court enunciated the fundamental principle governing corporate taxation:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors . . . so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. 319 U.S. at 438.

This Court has recently reaffirmed the *Moline Properties'* doctrine in *Commissioner v. Bollinger,* 485 U.S. 340 (1988), stating that "a corporation is a separate taxable entity even if it has only one shareholder who exercises total control over its affairs." 485 U.S. at 345. That the separate entity doctrine has also been accepted by Respondent in the context of an S corporation is demonstrated by its failure to "nonacquiesce" to the Tax Court's decision in *Crook v. Commissioner,* 80 T.C. 27, 33 (1983), *aff'd without opinion,* 747 F.2d 1463 (5th Cir. 1984).[24]

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[24] The Commissioner of Internal Revenue issues either an "acquiescence" or "non-acquiescence" with respect to many Tax Court decisions in order to inform the field staff of the Service throughout the country, as well as the general public, how the Service intends to handle cases with similar fact patterns in the future. The acquiescence or non-acquiescence generally remains in effect until a number of lower courts issue opinions contrary to the Service's position, this Court issues an

Yet, the court below appears to believe that the S corporation and its shareholders are not separate taxable entities filing separate income tax returns. The court's contention that the shareholder's return is the relevant return for statute of limitations purposes disregards the S corporation as a separate entity and the S corporation's income tax return as a separate income tax return. This view is inconsistent with the concern expressed by this Court in *Bollinger* that the separate entity doctrine of *Moline* not be subverted. 485 U.S. at 340.

It is always the C corporation's income tax return that begins the running of the statute of limitations. By contending that a different statute of limitations rule applies to an S corporation because an S corporation, unlike a C corporation, is not a taxable entity or is generally not a taxable entity, the Second Circuit ignored the fact that a C corporation, during one or more of its taxable years, may not be liable for any tax because it has suffered a loss rather than having taxable income. The Service certainly would not assert that in such cases the three-year period of limitations under section 6501(a) is inapplicable to the C corporation's income tax return.

It is altogether reasonable for Congress to have limited the vulnerability to audit of the shareholder of the S corporation to the three-year period during which the corporation is required to retain its records for the taxable year. The court below dismissed this concern cavalierly: "We believe that a shareholder of an S corporation can take . . . protective steps with regard to the S corporation records needed to support the S corporation items claimed on the shareholder's return." J.A. 72. It is difficult to say what basis, however, the court below had for this conclusion. As of 1979, S corporations could have up to fifteen shareholders. It is very easy to conceive of circumstances in which a one-fifteenth shareholder would

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opinion with respect to the fact pattern, or Congress acts to resolve the issue legislatively.

have absolutely no control over the actions of a corporation's management.[25]

In addition, Congress could well have perceived a need for a single limitations period applicable to all corporations. Under the rules that Congress established in 1958, corporations could lose their qualification for treatment under subchapter S by violating any of a number of sometimes detailed rules, notably those denying qualification if more than twenty percent of the corporation's income was derived from "passive" sources. (Partnerships, in contrast, generally were not subject to such rules.[26]) As a practical matter, Congress likely envisioned that the Service would seek to examine the corporation's eligibility for subchapter S status, and the validity of the corporation's report of its various items of income, deduction, and credit in the same tax audit. It was thus natural in 1958 for Congress to have based the applicable limitations period on the filing of the S corporation's return as is the case for a C corporation.

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[25] This court also should not view a shareholder's "voluntary" consent to extend the limitations period for the shareholder's individual return as in any way reflecting a considered decision, by the shareholder, that S corporation records remain available. During the course of an audit, the Service almost invariably asks the taxpayer to consent to an extension of the limitations period. If the taxpayer refuses, Respondent's normal practice is to assess a very high deficiency, based on the Service's estimate as to the taxpayer's maximum possible exposure. Thus, in practice, the taxpayer typically has no real choice but to "consent" to the extension.

[26] The question will occasionally arise whether an entity designated as a partnership should nevertheless be taxed as a corporation. Because of the tax benefits sometimes associated with partnership status, the tax law does not consider an entity's formal characterization as a partnership, under state law, to be determinative for tax purposes. Instead, under a "corporate resemblance" test, the Service can recharacterize a partnership as a corporation in some circumstances if the legal arrangements among the partners (*e.g.*, with respect to centralized management and free transferability of interests) are typical of those normally made among shareholders. *See* 26 C.F.R. §301.7701-1 *et seq.* The Code does not, however, contain precise requirements for partnership status analogous to those applicable to subchapter S corporations. It is unusual for a partnership to be recharacterized as a corporation under the regulatory "corporate resemblance" test, and in practice the test is sparingly applied.

Furthermore, because the primary motivation for entrepreneurs to use an S corporation was to make possible the deduction of corporate losses, Congress very likely expected that many shareholders would revoke their subchapter S elections after the initial years of a venture, when startup losses turned to profits. Indeed, such a practice became quite common following the enactment of subchapter S in 1958. Congress therefore likely contemplated that, for much of their corporate existence, corporations established originally as subchapter S corporations would, in fact, be subject to the regular rules of corporate taxation. It was consequently quite natural for Congress to treat a subchapter S income tax return consistently with a subchapter C income tax return.

B. AN S CORPORATION IS A CORPORATION AND SHOULD NOT BE TREATED LIKE A PARTNERSHIP.

Subchapter S of the Code was enacted in 1958 to provide rules for small business corporations to elect to be taxed differently from C corporations.[27] It is often said that S corporations are taxed, like partnerships, as passthrough entities.[28] This characterization is not accurate. Congress did not choose to apply subchapter K partnership rules to S corporations.[29] Rather, it added subchapter S to the Code, which,

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[27] Technical Amendments Act of 1958, Pub. L. No. 85-866, §64, 72 Stat. 1606.

[28] *Fehlhaber v. Commissioner*, 954 F.2d at 655; and *Green v. Commissioner*, 963 F.2d at 786.

[29] In The Revenue Act of 1954, Pub. L. No. 83-591, 68A Stat. 1, section 1361 was enacted to permit sole proprietorships and partnerships to elect to be taxed as C corporations. The Senate also attempted to add section 1351 to the Code which would have allowed corporations to elect to be treated as partnerships. S. Rep. No. 1622, 83rd Cong., 2d Sess. 1, 118. The Senate simply provided that all the partnership rules of subchapter K applied to these electing corporations including formation, operation, distributions, liquidation, sales of interests, and any other purposes. This Senate bill was deleted by Amendment No. 259 of the Conference Committee. H.R. Rep. No. 2543, 83rd Cong., 2d Sess. 1, 72.

while bearing some similarity to subchapter K, also created unique provisions to retain the separate entity doctrine that applies to S corporations.

Respondent suggests that there is no reason for Congress to have departed from the partnership approach. In fact, there are ample reasons why Congress in 1958 would have desired to establish, in its rules governing subchapter S returns, a regime different from that applying to partnerships. Most important is the dependence of the shareholder's liability on the amount of the corporation's "earnings and profits." Congress would logically have desired to permit adjustments to the shareholder's returns only during such period as the corporation remained on notice of the need to retain detailed financial records. Statutes of limitations, under the tax laws, serve the important purpose of signalling to the taxpayer the period during which it is necessary to keep detailed records.[30] As this Court noted in *Rothensies v. Electric Storage Battery Co.*: "a statute of limitations is an almost indispensible element of fairness as well as of practical administration of an income tax." 329 U.S. 296, 301 (1946).

In this respect Congress could well have been influenced by the different levels of control over the entity held by partners and shareholders, especially minority shareholders, under the traditional common law. A partner, traditionally,

In 1958, when subchapter S of the Code was added, Congress rejected its previous approach to applying subchapter K provisions to electing small business corporations. Rather, it adopted subchapter S which contains many provisions different from subchapter K. The application of subchapter K provisions to electing small business corporations was considered and rejected, and as such its absence from the taxing regime of these corporations reflects Congress' intent that application of the partnership provisions is inappropriate.

[30] The statute of limitations exists, in part, so that after some time persons can be confident that their affairs are closed and they can dispose of old records. An S corporation should be entitled to the same finality as other entities, yet if any shareholder has given an extension of the statute of limitations to the Service, the shareholder's ability to defend against the adjustment would (under the government's view of the issue in this case) depend upon whether the corporation has retained the records. *Kelley, supra*, 877 F.2d at 758.

participates actively in partnership management and exercises direct control over the entity's affairs.[31] In contrast, a shareholder of a corporation, even one with only ten shareholders, may have little if any influence on the corporation's day-to-day affairs, and may have little control over the retention of corporate records.

The differences between subchapter S (small business corporations) and subchapter K (partnerships) have become more marked during the years since 1958. Taxes have been imposed on S corporations since 1966 but not on partnerships. Subchapter S rules were simplified in 1982, but nothing has changed the original intent of Congress to maintain a separate set of rules for S corporations and partnerships.

In *Flynn v. Commissioner*, 93 T.C. 355 (1989), the Tax Court cited the following language of Senate Report No., 97th Cong., 2d Sess:

> Because of the passthrough of income and loss to the shareholders of a subchapter S corporation, subchapter S is often described as a method of taxing corporations as if they were partnerships. In fact, *there are a number of significant differences* in tax treatment under the partnership provisions (subchapter K) and the subchapter S provisions. 93 T.C. at 362 (emphasis added).

Just as Congress did not adopt the partnership model in the substantive treatment of S corporations, Congress departed from the partnership model in the limitations area. As of 1979, section 6031 contained the following requirement with respect to partnerships:

> Every partnership . . . shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, and such other information for the purpose of carrying out the provisions of subtitle A as

[31] This is not, of course, true of the contemporary limited partnership. It would seem likely, however, that in 1958, most legislators' perceptions of a partnership would have been influenced more strongly by models of the traditional general partnership than of the limited partnership.

> the Secretary may by forms and regulations prescribe, and shall include in the return the name and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual.[32]

The corresponding provision for subchapter S corporations contains language similar, *but not identical*, to that of the provision applying to partnerships. Section 6037 of the Code provides:

> Every electing small business corporation (as defined in section 1371(b)) shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, the names and addresses of all persons owning stock in the corporation at any time during the taxable year, the number of shares of stock owned by each shareholder at all times during the taxable year, the amount of money and other property distributed by the corporation during the taxable year to each shareholder, the date of each such distribution, and such other information, for the purpose of carrying out the provisions of subchapter S of chapter 1, as the Secretary may by forms and regulations prescribe. *Any return filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as a return filed by the corporation under section 6012.* (emphasis added).

This highlighted language contrasts Section 6037 with the corresponding provision governing partnerships; in the words of the court below, Section 6031(a), governing partnership returns, "has no similar provision relating to the effect of those returns on the limitations period." J.A. 70. Section 6037 clearly reflects a deliberate decision to apply different rules of limitation to partnerships and S corporations.

[32] The language of this statute has not changed between 1958 and the present, except that the words "or his delegate" following "Secretary" were removed in 1976. Pub. L. No. 94-455, Sec. 1906(b), 90 Stat. 1834.

Prior to its decision in *Bufferd*, 952 F.2d 675 (2d Cir. 1992), the Second Circuit, too, recognized the distinction between an S corporation and a partnership. When it held in *Siben v. Commissioner*, 930 F.2d 1034 (2d Cir. 1991), that the Service may make adjustments on a partner's return with respect to partnership items, notwithstanding the expiration of the three-year statute of limitations period for the partnership return, it distinguished *Kelley v. Commissioner*, 877 F.2d 756 (9th Cir. 1989), which dealt with an S corporation.

In distinguishing an S corporation from a partnership in *Siben*, the Second Circuit noted its earlier decision in *Ketchum v. Commissioner*, 697 F.2d 466 (2d Cir. 1982). The court stated in *Ketchum* that "as long as the sections of the Code governing subchapter S corporations differ from the partnership provisions, *we are obliged to apply those sections differently*, and taxpayers will gain or lose from those differences as the case may be." 697 F.2d at 471 (emphasis added). The court noted in *Siben* that "§6037, relating to S corporations, has no counterpart in the partnership provisions." 930 F.2d at 1037. Thus, as explained in *Ketchum* and reiterated in *Siben*, Congress chose to treat S corporations differently from partnerships and created a separate statutory scheme to reach its objective.

In its decision below, the Second Circuit ignored its own admonition to treat an S corporation differently from a partnership. Rather, the court concluded that the income tax return of the S corporation's shareholder, like a partner's income tax return, determines the period of limitations under section 6501(a). Yet, as the Second Circuit itself recognized, there is no provision in the Code for partnership returns analogous to the second sentence of section 6037(a).[33] Nor does section 6012 designate a partnership as a person required to file a return. Despite the Second Circuit's recognition of the difference in the statutory schemes governing S corporations and partnerships (*Siben*, 930 F. 2d at 1037; *Ketchum*,

[33] Section 6031 of the Code does provide a rule for partnerships analogous to the first sentence of section 6037(a).

697 F.2d at 471), it failed to grasp the significance of these differences and consequently did not reach a different result in *Bufferd* from the result in *Siben*. *Bufferd*, 952 F.2d at 677.

C. AN S CORPORATION RETURN IS A TAX RETURN, NOT AN INFORMATION RETURN.

An S corporation return is a tax return like that of a C corporation and not an information return like that of a partnership. Therefore, it is to the S corporation's return that section 6501(a) refers, in every year in which the S corporation is required to file a return. Section 6012(a)(2) requires an S corporation to file a return every year, not merely in years in which it is subject to tax. Congress did not limit the applicability of section 6012(a)(2) to C corporations and invalidly-elected S corporations.

The second sentence of section 6037(a), which plainly includes "any" S corporation return, refers to section 6012, as the paragraph requiring a corporation to file an income tax return and to Chapter 66, the chapter containing the limitations provisions. Paragraph (2) of section 6012(a) is the only paragraph in section 6012 applicable to a corporation and section 6501(a) is the section in Chapter 66 that contains the limitations rule for returns filed pursuant to section 6012. Although section 6012(a)(2) refers to a corporation subject to taxation, and no income taxes were imposed on S corporations at the time that Congress drafted the second sentence of section 6037(a) in 1958, section 6037(a) clearly states that the S corporation return shall be treated as the return required by section 6012 that begins the limitations period. Furthermore, S corporations have been "subject to taxation" since the 1966 amendments.[34]

[34] Beginning in 1966, section 1378 imposed an S corporation-level income tax on certain S corporation capital gains. Small Business Corporations Act, Pub. L. 89-389, §2(a), 80 Stat. 111. Because these capital gains were so-called "preference" items under section 57 of the Code, an S corporation taxable under section 1378 might be subject to the "minimum tax" under sections 56 and 58(d)(2) of the Code then in effect. Section 1378 was re-enacted as section 1374 in 1982. Subchapter S

The notion that an S corporation's return is a "return" only when the corporation actually has tax liability is also contrary to Respondent's own regulation. In September 1958 the Treasury proposed, and in February 1959 adopted, Regulation section 1.6012-2(a)(1), which provides that "every corporation as defined in section 7701(a)(3), subject to taxation under subtitle A shall make a return of income *regardless of whether it has taxable income*. . . . " (emphasis added). This regulation, issued almost contemporaneously with the enactment of section 6037(a) in 1958, strongly militates against giving a subchapter S corporation's return significance only when it has a tax liability.

When Respondent argued in the Second Circuit that there is no tax to be assessed under section 6501(a) with respect to an S corporation, and thus there is no applicable limitations period with respect to an S corporation return, it relied upon *Leonhart v. Commissioner*, 27 T.C.M. (CCH) 443, *aff'd per curiam*, 414 F.2d 749 (4th Cir. 1969). Respondent's reliance on *Leonhart* is misplaced. First, the Tax Court in *Leonhart* implicitly, with no analysis, made the same mistake as the Second Circuit made here in connecting the word "return" with the word "assessment" in section 6501(a). Even before enactment of section 1378 imposing a corporate level tax, there was always an occasion for a period of limitations with respect to an S corporation given a proper interpretation of the word "return" in section 6501(a). There is no inextricable linkage between the taxpayer making the return and the taxpayer against whom there can be an assessment.

Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669. It was then modified in both 1984 and 1986, imposing different S corporation-level income taxes on S corporations. Deficit Reduction Act of 1984, Pub. L. No. 98-369, §721(v), 98 Stat. 971 and Tax Reform Act of 1986, Pub. L. No. 99-514, §632(a), 100 Stat. 2275. Modifications to section 1378 as originally enacted all occurred after the taxable year at issue in this case. Nevertheless, it is clear that from 1966 through the present, an S corporation is a "corporation subject to taxation" described in section 6012(a)(2).

Second, even if the Tax Court was correct in *Leonhart*, its conclusion is no longer valid. Vital to the *Leonhart* holding and, therefore, to Respondent's argument, is the notion that a validly-elected S corporation will never be subject to taxation. (*Leonhart* concerned a year prior to enactment of section 1378 when no tax could be assessed on an S corporation.) Indeed, in *Leonhart* the Tax Court stated:

> [W]here an eligible small business corporation makes a valid election under Subchapter S the statute contemplates that no income taxes are to be paid by it and therefore that there would be no occasion for a period of limitation on assessment and collection with respect to the corporation. 27 T.C.M. (CCH) at 462.

While there was no tax imposed at the S corporation level for the taxable year at issue in *Leonhart*, this is no longer true. Under section 1378, enacted in 1966 after the tax year in question in *Leonhart*, a tax can be imposed on the income of an S corporation if the S corporation has a recognized capital gain for the taxable year or is subject to the minimum tax. Thus, after 1966 and continuing to the present, an S corporation is a "corporation subject to taxation" under section 6012(a)(2).

Paramont Land Company, Inc. v. United States, 727 F.2d 322 (4th Cir. 1984), illustrates the manner in which an S corporation may be taxed at the corporate level on capital gains income notwithstanding a valid S corporation election. The Court of Appeals for the Fourth Circuit, finding that Paramont Land met the requirements detailed in section 1378, held that income received by the S corporation from leasing coal properties was a capital gain within the meaning of section 1378's statutory exception to the general scheme of treatment for subchapter S taxpayers. The court thus affirmed the assessment of tax under section 1378 at the S corporation level. 727 F.2d at 324.

The enactment of section 1378, as demonstrated in the *Paramont Land* case, renders *Leonhart* inapplicable to post-1966 cases. To argue that an S corporation is not a

taxable entity, and, thus, not subject to a limitations period, is contrary to the explicit, unambiguous provisions of the Code.

The enactment of section 1378 transformed an S corporation into a taxable entity. Since its enactment, an S corporation, unlike a partnership, is subject to taxation in some years, although it may not be taxed in all years. The Second Circuit pointed out in *Klein v. Commissioner*, 537 F.2d 701, 704 (2d Cir. 1976), *cert. denied*, 429 U.S. 980 (1976), that a partnership can never be a taxable entity and can never be subject to any tax imposed by the Code.[35]

The three circuit courts in *Bufferd*, *Fehlhaber*, and *Green* attempt to create a new exception to corporations described in section 6012(a)(2): corporations not "generally" subject to income taxation. For example, in *Fehlhaber* the Eleventh Circuit stated:

> Most importantly, section 6012 provides, in relevant part, that '[e]very corporation subject to taxation *under subtitle A*' is required to file an income tax return. This reference strains Fehlhaber's interpretation because, as we noted above, an S corporation is a *'flow-through' entity* and is not *generally* separately taxable. *Fehlhaber*, 954 F.2d at 656 (emphasis added).

The attempt to categorize corporations not generally subject to income taxation as exempt from the filing requirements of section 6012(a)(2) is incorrect. Section 6012(a)(2) provides that even in years when no tax liability is imposed at the S corporate level, an S corporation is "subject to" taxation, and pursuant to both sections 6012(a)(2) and 6037(a) it must file a return. Indeed, as noted, the applicable Regulation provides "[e]very corporation, as defined in section 7701(a)(3), subject to taxation under subtitle A of the Code shall make a return of income regardless of whether it has taxable income or regardless of the amount of its gross income." Regulation section 1.6012-2(a)(2). There is simply no language in the Code (or Regulations) that creates an

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[35] The Second Circuit in *Klein* referred only to income taxes. Partnerships are, of course, subject to a number of other taxes, *e.g.*, employment taxes.

exception to the explicit directive of sections 6012(a)(2) and 6037(a) that all corporations, including all S corporations, must file yearly income (not information) tax returns.

Respondent's argument that an S corporation's income tax return, Form 1120S, is an information return, as is the case with a partnership or an exempt organization's return (*see, Automobile Club of Michigan v. Commissioner,* 353 U.S. 180 (1967)), is wholly without merit.[36] The Service promulgated Form 1120S for 1978 (the S corporation's taxable year at issue). The Service did not designate the Form 1120S as an information return. Rather, the Service titled the Form 1120S as "U.S. Small Business Corporation Income Tax Return." The S corporation, Compo, filed a return on Form 1120S for the taxable year ending November 30, 1979 (J.A. 38-42).

Compo's Form 1120S was not merely an information return. On lines 29-31 on the 1978 Form 1120S, the Service provided for the reporting, at the corporate level, of the S corporation's tax liability: income tax on capital gains (line 29), minimum tax (line 30), and total tax (line 31). In addition, the Service promulgated a separate Schedule D to accompany Form 1120S allowing the S corporation to compute its capital gains and capital losses. Lines 29-31 on Form 1120S provide clear evidence that the Service recognizes an S corporation as a separate taxable entity. This form has provided for the computation of an S corporation level tax since the enactment of section 1378 in 1966. This form refutes Respondent's argument that an S corporation is a pure pass-through entity like a partnership and that its return is merely an information return.

The Service also promulgated Form 1065, "U.S. Partnership Return of Income." There is no provision on Form 1065

[36] The Petitioner believes that *Automobile Club of Michigan v. Commissioner,* 353 U.S. 180 (1967), is not relevant to this case. In that case the organization was declared to have violated tax exempt organization status and therefore was taxed as a C corporation. This is analogous to a situation in which an S corporation made an invalid election.

for the computation of any tax because, unlike an S corporation, a partnership is never a taxable entity. Nor is the partnership return titled an "Income Tax Return." Thus, on its own forms the Service treated an S corporation as a separate taxable entity while treating a partnership as a pure pass-through entity.

By erroneously equating an S corporation income tax return, Form 1120S, and a partnership information return, Form 1065, the Eleventh Circuit mistakenly concluded that the S corporation's income tax return is merely the information return of a passthrough entity.[37] But an S corporation return is not merely an information return and an S corporation is not merely a passthrough entity. As a result of section 1378, it is a "corporation subject to taxation" under section 6012(a)(2). Thus, the return of an S corporation is an income tax return.

The Second Circuit ignored the statutorily prescribed function of the S corporation return, Form 1120S, as an income tax return. Its view of the function of the return ascribes a dual nature to an S corporation's income tax return. If an S corporation owes any tax for a taxable year, its return for that taxable year constitutes an income tax return. If, however, that same S corporation does not owe any tax for a taxable year, its return constitutes an information return. This judicial alchemy produces the absurd result that a tax liability of one dollar owed by the S corporation, whether or not originally reported on the return, changes the status of the return from an information return to an income tax return. It also changes the return that begins the running of the statute of limitations under section 6501(a) from the income tax return of the S corporation's shareholder to the S corporation's income tax return.

Acceptance of this construction would unjustly magnify the importance of the financial activities of an S corporation in any taxable year. Applying the more natural construction to the language of these three Code sections requires that the

[37] *Fehlhaber v. Commissioner,* 954 F.2d at 657.

nature of the entity, rather than the nature of the transactions of a given taxable year, determines the identity of the "return" that begins the running of the statute of limitations.

III

RESPONDENT'S ARGUMENTS FOR IGNORING THE STATUTE'S PLAIN MEANING ARE WITHOUT MERIT.

A court need only resort to the legislative history when there are "patent ambiguities" in the statutory language. *American Community Builders v. Commissioner*, 301 F.2d 7, 13 (7th Cir. 1962); *accord, United States v. Blasius*, 397 F.2d 203, 206 (2d Cir. 1968). Even if the statutory scheme were not clear and unambiguous on its face, however, the legislative history substantiates the position of the Petitioner and the Ninth Circuit.

Congress enacted subchapter S and section 6037 in 1958.[38] In relevant portion, the 1958 Report of the Senate Finance Committee on the Technical Amendments Act[39] that added subchapter S and section 6037 to the Code, provides:

> Notwithstanding the fact that an electing small-business corporation *is not subject to the tax* imposed by chapter 1 of the 1954 Code, such corporation *must make a return* for each taxable year in accordance with new section 6037 as added by subsection (c) of section 68 of the bill. *Such return* will be considered as *a return filed under section 6012* for purposes of the provisions of chapter 66, relating to limitations. Thus, *for example, the period of limitation on assessment and collection of any corporate tax found to be due upon a subsequent determination that the corporation was not entitled to the benefits of subchapter S, will run from the date of filing of the return required under the new section 6037.* S. Rep. No. 1983 at 5014 (emphasis added).

[38] Technical Amendment Act of 1958, Pub. L. No. 85-866, §64(c), 72 Stat. 1606.

[39] S. Rep. No. 1983, 85th Cong., 2d Sess. 1019, *reprinted in* 1958 U.S. Code Cong. & Admin. News 5005 (hereinafter "Senate Report").

On the basis of this language, Respondent suggests that the second sentence of section 6037(a), describing an S corporation's return as one that satisfies section 6012 and begins the period of limitations, applies only when the S corporation is subject to tax or its election is invalid. This is untrue. The second sentence of section 6037(a) clearly provides on its face that "*any return* filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as filed by the corporation under section 6012" (emphasis added). An interpretation of the legislative history of section 6037(a) that limits the application of the sentence only to entities that are ineligible for treatment as S corporations ignores the "any return" language contained in the statute itself.

When Congress enacted section 6037(a) in 1958, a determination that the corporation was not entitled to the benefits of subchapter S was the *only* occasion on which an S corporation could itself be subject to tax.[40] The first sentence of the Senate Report clearly demonstrates that, at the time section 6037(a) became effective, Congress knew that an electing small business corporation was not subject to the tax imposed by Chapter 1. Section 6037(a) was not needed if it was to

[40] In order for a corporation, normally subject to taxation as a C corporation, to be treated as an S corporation, it must satisfy two requirements. First, it must make a proper election that fulfills all requirements prescribed by section 1372. Second, it must also qualify as a "small business corporation" pursuant to the definition in section 1371. Thus, a corporation will not be eligible to be taxed under subchapter S if it fails to satisfy either the procedural election requirement under section 1372 or the substantive definitional requirement under section 1371. Beginning in 1966, Congress provided for various other circumstances in which the subchapter S corporation could itself become subject to taxation. *See, e.g.*, Pub. L. 89-389, §2(a), 80 Stat. 111 (1966) (adding initial version of 26 U.S.C. §1378, subsequently amended many times, subjecting subchapter S corporation to taxation on certain extraordinary capital gains). Under the 1958 version of the statute, however, in which Congress enacted section 6037(a), a subchapter S corporation could become subject to taxation *only* if its election was terminated.

apply only to ineligible S corporations. An ineligible S corporation would automatically be subject to the existing rules for C corporations.

Congress also knew when it added section 6037(a) that the paragraph in section 6012(a) only that referred to a corporation was paragraph (2). Yet, Congress drafted the second sentence of section 6037(a) to provide that *any return* of an S corporation shall be treated as a return filed by the *corporation* under section 6012. Thus, Congress could not have intended that the S corporation return filed under section 6012 be only a return under section 6501(a) when the S corporation election was invalid or the S corporation was subject to taxation.

The words "for example" in the legislative history of section 6037(a) indicate that Congress did *not* intend its reference to the statute of limitations in section 6037(a) to apply *only* when the subchapter S corporation, itself, was subject to taxation.[41] This Court stated in *Pension Benefit Guaranty Corporation v. LTV Corporation,* that:

> An example, after all, is just that: an illustration of a statute's operation in practice. It is not, as the Court of Appeals apparently thought, a definitive interpretation of a statute's scope. 496 U.S. 633, 649 (1990).

The notion that a corporation's return is a "return" only when the corporation actually has tax liability is also contrary to Respondent's own regulation. In September 1958 the Treasury proposed, and in February 1959 adopted, the Regulation section noted above that requires every corporation to make a

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[41] To the extent that legislative history is important, its language, as well as the language of the statute itself, should be given its plain meaning. An "example" is a particular case, incident, etc., *that is representative of a broader class.* An example is –

> [a] typical instance; a fact, incident, quotation, etc. that illustrates, or forms a particular case of, a general principle, rule, state of things, etc. . . . 5 Oxford English Dictionary 489 (2d ed. 1989).

It strains credibility that the drafters of the 1958 legislative history would have used the words "for example" if they had intended to describe the *only* application of the final sentence of Code §6037(a).

return of income *regardless of whether it has taxable income.*[42] This regulation, issued almost contemporaneously with the enactment of Section 6037(a) in 1958, strongly militates against giving an S corporation's return significance only when the S corporation has a tax liability.

The more logical view is that the legislative history provides merely *one example* of the purpose of the second sentence of section 6037(a): that section 6012 will control when a purported S corporation that has not validly elected subchapter S files an income tax return. The last sentence of the Senate Report merely illustrates the period of limitations treatment for an S corporation whose election is invalid. If a corporation invalidly elects to be an S corporation, it is treated as a C corporation. The last sentence contains no statement concerning a corporation that makes a valid S corporation election. The Second Circuit's conclusion by negative implication that the period does not also run for a validly-elected S corporation's income tax return from the date it files its return (as it does for a C corporation) requires a leap of faith, not logic.

Congress could, if it had wished, easily have accomplished the result suggested by the Second Circuit. Congress did not do so, however. Section 6037(a) simply does not contain the language of limitation that Respondent would read into the statute and legislative history.

The reliance of the court below on the legislative history's use of this *one example* of when the second sentence of section 6037(a) and section 6012 could trigger the running of the statute elevates the importance of what is merely one example and denies effect to the second sentence of section 6037(a) but for the exceptional case of an invalid election. Most importantly, it allows the example to swallow the whole statute and effectively to write section 6012(a)(2) and the second sentence of section 6037(a) out of the Code. *See, Kelley v. Commissioner,* 877 F.2d at 759.

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[42] Regulation §1.6037-1(c).

This was the mistake of the Tax Court in *Leonhart v. Commissioner*, 27 T.C.M. (CCH) 443 (1968), *aff'd per curiam*, 414 F.2d 749 (4th Cir 1969). The Tax Court looked to the language of the Senate Report but ignored the second sentence of section 6037(a) which provides that a return filed under section 6037(a) will be treated as a return filed under section 6012(a)(2). Section 6037(a) does not provide that the S corporation's income tax return will be treated as a "return" only if its election is invalid, nor does it differentiate an S corporation's return from a C corporation's return for purposes of section 6012(a)(2). Therefore, an S corporation's return, like a C corporation's return, must be treated as a return for purposes of the provisions of chapter 66, relating to limitations.

The Tax Court continued its myopia by relying on *Leonhart* in its decision in *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990), and in adopting *Fehlhaber* in this case. There were no S corporation level taxes to be assessed in 1958 when 6037(a) was promulgated, in 1959 when Regulation section 1.6037-1(c) was promulgated, or in 1960 and 1961, the tax years at issue in *Leonhart*. Such taxes were enacted in 1966 and imposed beginning in 1967 and have continued, although modified, to the present.

In 1966, subchapter S was amended to include section 1378.[43] Since then, an S corporation has been a taxable entity. Section 1378 imposed a corporate level tax on validly-electing S corporations with respect to certain capital gains.[44] Although section 6037(a) predates this corporate level tax, it states with no modification that an S corporation must file a

[43] Small Business Corporations Act, Pub. L. 89-389, §2, 80 Stat. 111 (1966).

[44] Because these capital gains were so-called "preference" items under section 57 of the Code, an S corporation taxable under section 1378 might be subject to the "minimum tax" under sections 56 and 58(d)(2) of the Code then in effect. The Deficit Reduction Act of 1984, Pub. L. No. 98-369, §721(v), 98 Stat. 971, also amended subchapter S to include section 1375(d) which imposes a corporate level tax on those S corporations that have certain amounts of passive income; and, the Tax Reform Act of 1986, Pub. L. 99-514, §632(a), 100 Stat. 2275, imposed a corporate level tax on S corporation liquidations.

tax return and that this return will be treated for statute of limitation purposes as a return filed by the corporation under section 6012. The Second Circuit failed to consider adequately the relationship between the date of enactment of section 6037(a) and the later changes to subchapter S.

Respondent suggests [Brief in Response to Petitioner for Certiorari (hereinafter "Br. Resp.") 13-14], that its interpretation of the pre-1982 statute is supported by the 1982 amendments that plainly changed the rules in this area. No such conclusion can be drawn. In that year, Congress changed the audit procedures for both partnerships and S corporations, for the purpose of simplifying the procedures for entities having large numbers of members.[45] For example, Congress generally required such entities to designate members who will be responsible for dealing with the Service and provided special rules for the issuance of deficiency notices and related procedures. At the same time, Congress specified that, for the larger entities affected by the new legislation, an extension of time either by the entity (with respect to the entity as a whole), or by the individual partner or S corporation shareholder (with respect to that partner or shareholder only), would extend the applicable period of limitations.

No inference can be drawn from these changes that Congress, in the pre-1982 period, wished to treat subchapter S returns as Respondent argues or to equate subchapter S corporations and partnerships. The 1982 amendments made wholesale changes to the treatment of S corporations to make them generally more like partnerships. Most notably, Congress removed the general dependence of an S corporation shareholder's income on the "earnings and profits" of the corporation, and instead substituted a passthrough regime similar to

[45] In explaining its substantial rewriting of subchapter S rules in 1982, the Congressional committees described pre-1982 subchapter S as incorporating "modified corporate rules", H.R. Rep. No. 826, 97th Cong., 2d Sess. 6 (1982); S. Rep. No. 640, 97th Cong. 2d Sess. 6 (1982).

that applying to partnerships.[46] Congress fully recognized the significance of its actions in this regard. In the words of both the House and Senate reports:

> The committee believes that partnership-like rules which pass items of income and loss through to the corporation's shareholders, with distributions being generally a return of the shareholder's investment including previously taxed earnings, is a simpler and more rational taxing scheme than the modified corporate rules of present subchapter S. Therefore, the bill adopts a partnership approach which treats all items, including such items as depletion, foreign income, and fringe benefits generally like they are treated under the partnership provisions. H.R. Rep. No. 826, 97th Cong., 2d Sess. 6 (1982); S. Rep. No. 640, 97th Cong., 2d Sess. 6 (1982).

In short, while the 1982 legislation changed the rules for future years, it implied nothing about the past.[47] Nevertheless,

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[46] Although Congress moved much closer to a partnership model for subchapter S in 1982, Congress did not remove all dependence on corporate concepts. Earnings and profits, for example, continue to be significant in the taxation of those S corporations that have earnings and profits left over from years when they were not S corporations. *See especially* 26 U.S.C. §1368 (dealing with distributions from S corporations). As a general matter, however, the 1982 changes to subchapter S have rendered earnings and profits much less important.

[47] Respondent cites language from the 1982 legislative history that purports to describe prior law in a manner consistent with the views of respondent. Br. Resp. 13-14, *citing* H.R. Rep. No. 826, *supra*, at 24; S. Rep. No 640, *supra*, at 25. This 1982 language, of course, has no formal bearing on the interpretation of a statute that Congress enacted in 1958. "[T]he views of some Congressmen as to the construction of a statute adopted years before by another Congress have 'very little, if any, significance.' " *United States v. Clark*, 445 U.S. 23, 33 n.9 (1980), *quoting United States v. Southwestern Cable Co.*, 392 U.S. 157, 170 (1968), and *Rainwater v. United States*, 356 U.S. 590, 593 (1958). Congress' 1982 musings on the 1958 statute cannot represent "an authoritative interpretation of what the [earlier] statute meant . . . since it is the function of the courts and not the Legislature . . . to say what an enacted statute means." *Pierce v. Underwood*, 487 U.S. 552, 565-66 (1988). Congress, in 1982, may authoritatively have determined the place that section 6037(a) would occupy in its *new* statutory regime for S corporations, but Congress

the Tax Court in *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990) (the opinion it adopted in this case) refers to the Subchapter S Revision Act of 1982[48] (hereinafter "Revision Act"), and looks at the legislative history of the Revision Act in its attempt to determine the meaning of earlier legislation. 94 T.C. at 867. It recites the following language from the Senate Report on the Revision Act explaining the legislation:

> Under present law, a taxpayer's individual tax liability is determined in proceedings between the Internal Revenue Service and the *individual* whose tax liability is in dispute. Thus, any issues involving the income or deductions of a subchapter S corporation are determined *separately* in administrative or judicial proceedings involving the individual shareholder whose tax liability is affected. Statutes of limitations apply at the individual level, based on the returns filed by the individual. The filing by the

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in 1982 cannot have decided the meaning of section 6037(a) for years *prior* to the effective date of the 1982 enactments.

Moreover, to the extent post-enactment legislative history is deemed at all important the 1982 committee report language should be balanced against that used in more recent reports. H.R. 4210, the Tax Fairness and Economic Growth Bill of 1992, was passed by both Houses of Congress but vetoed by the President. The bill, at §4907, contained language that would have established, *for taxable years beginning after the date of enactment*, that the limitations period with respect to S corporation items was to be determined by reference to the return filed by the shareholder, not the corporation. The 1992 conference report contains the following language:

> The . . . bill clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit. *The provision is not intended to create any inference as to the proper interpretation of present law.* [Emphasis added.]

H.R. Conf. Rept. No. 461, 102d Cong., 2d Sess. 637 (1992). The provision contained in §4907 of H.R. 4210 remains "alive" on Capitol Hill as an apparently noncontroversial measure, and appears likely to be included the next time Congress passes comprehensive tax legislation. *See* H.R. Rep. No. 631, 102d Cong., 2d Sess. 280 (June 30, 1992) (including the provision in legislation reported by the House Ways and Means Committee).

[48] Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669.

corporation of its return does not affect the statute of limitations applicable to the shareholders (emphasis added).[49]

Even if reference to the legislative history of a later act is a valid source of support concerning the meaning of the earlier legislative history and statute, the Senate and House Reports supporting the Revision Act contain nothing that refutes the Petitioner's position. An S corporation's income tax return is to be treated, for purposes of statute of limitations, *separately* from the return of the S corporation's shareholders. Further, the period of limitations on the *individual* return of the shareholder is governed by section 6012(a)(1) and not by section 6012(a)(2).

The language from the 1982 legislative history supports the Petitioner's position that there are two separate administrative or judicial proceedings possible, at both corporate and shareholder levels, and that the Service needs to seek extensions at both levels if the statute of limitations is due to expire at either level. The statute of limitations at the individual level runs from the filing of the individual's income tax return; the statute of limitations at the S corporation level runs from the filing of the S corporation's return.

As the 1982 legislative history states, the income, deductions, and tax credits of an S corporation are determined separately from its shareholders. Thus, all the legislative history supports the clear language of the Code that a separate three-year statute of limitations applies to both an S corporation and its shareholder, and that the Service should obtain separate extensions[50] of the period of limitations from the S corporation and its shareholders.

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[49] S. Rep. No. 640, 97th Cong. 2d Sess. at 25, 1982-2 C.B. 718, 729. The House Ways and Means Committee Report is identical. H. Rep. No. 826, 97th Cong., 2d Sess. at 24, 1982-2 C.B. 730, 741.

[50] Code §6501(c)(4).

IV

FAIRNESS AND FINALITY DICTATE PETITIONER'S CONSTRUCTION OF SECTIONS 6501(a), 6037(a), AND 6012(a)(2).

An S corporation is a separate entity, independent of its shareholders. It prepares and files its own tax return, independent of its shareholders. It then transmits limited information about that return to its shareholders by sending each shareholder a Schedule K-1 (J.A. 43-52). The shareholder's Schedule K-1 states only the information that a shareholder needs to complete his or her income tax return with respect to S corporation items. It does not state other corporate level information. It does not, for example, state whether the S corporation has been taxed. It does not contain information to make it possible for the shareholder to determine whether a tax should have been imposed or to determine whether the election to be taxed as an S corporation was valid.[51]

In the view of the Second Circuit, however, in some cases the S corporation's income tax return determines the expiration of the period of limitations while in others it is the shareholder's income tax return that controls. This interpretation makes it difficult for a shareholder to determine whether

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[51] The circuit court adopted Respondent's argument that because the S corporation's income tax return does not contain relevant information about a shareholder, including filing status, exemptions, deductions, or income, losses, or credits from other sources that would allow the Service to determine the shareholder's income tax liability, the appropriate return for purposes of the running of the period of limitations is the shareholder's income tax return. *See, Fehlhaber v. Commissioner*, 954 F.2d 653, 655 (1992).

A C corporation's income tax return also does not contain any such information. Yet, Respondent does not assert that the filing of the income tax return of the shareholder of a C corporation begins the running of the period of limitations with respect to items on the C corporation's income tax return.

The Service is not prevented from adjusting all items of income, deductions, filing status, credits, etc. on the shareholder's individual income tax return, when the statute of limitations on the individual income tax return has not expired. It is only the items that are determined at the S corporation level that he may not adjust if the limitations period has closed at the corporate level. This is also true for the shareholder of a C corporation.

examination by the Service of the S corporation's income tax return is closed for any particular taxable year because the shareholder does not know which return controls the limitations period. The shareholder also would not know whether the period of limitations was open for amending his or her income tax return with respect to S corporation items.

If application of the statute of limitations to the S corporation's income tax return hinges on whether the S corporation is or is not taxed, a shareholder, who only obtains a K-1 form, will never be confident that the statute of limitations has run on the S corporation's income tax return. If the S corporation's income tax return reflects a tax, its statute of limitations controls until and unless in a later examination of the return, the Service determines, in fact, that no tax was owed. At that point, the shareholder's income tax return becomes the one relevant for limitations purposes.

If the S corporation's income tax return shows no tax due, however, the shareholder's income tax return controls, until and unless in a later examination, the Service determines that a tax was, in fact, owed by the corporation. At that point, the corporation's return becomes the one relevant for limitations purposes. The shareholder has no access to information enabling him or her to monitor these shifting circumstances. A shareholder may ask the corporation to keep him or her informed but cannot compel the corporation to do so.

A shareholder must be certain of which records are relevant to a later examination by the Service and can only be responsible for those in his or her own possession and control. The burden should not be placed on the taxpayer to retain records indefinitely or to attempt to insure that the S corporation maintains its records indefinitely. To contend, as the Second Circuit does, that in some cases the shareholder's income tax return controls the period of limitations makes the shareholder responsible for actions taken and conclusions drawn at the corporate level. This both ignores the separation of the entity and the shareholder and, in many cases, unfairly imputes corporate actions to the shareholder.

The shareholder has neither possession nor control over the records of the S corporation. Although a shareholder may

ask the corporation to retain the records, a shareholder has no power to compel the corporation to comply with the request.

The Ninth Circuit stated:

> The shareholder can defend against such an adjustment only by resort to the corporations's books and records. The statute of limitations exists, in part, so that after some time persons can be confident that their affairs are closed and they can dispose of old records. An S corporation should be entitled to the same finality as others, yet if any of the shareholders has given an extension of the statute of limitations to the IRS the shareholder's ability to defend against the adjustment would depend upon whether the corporation has retained the records. *Kelley*, 877 F.2d at 758.

The circuit courts' view in *Fehlhaber*, *Green*, and this case is that expecting a shareholder to " 'take the necessary steps to ensure that the Corporation preserves the relevant records' " does "not constitute an overly oppressive task for the shareholder." *Green v. Commissioner*, 963 F.2d 783, 789 (5th Cir. 1992). The issue is not the degree of burden but the actual ability of a shareholder to compel a corporation to preserve records. The *Green* court noted that Mr. and Mrs. Brody[52] did not even know the names of other shareholders or the directors of the S corporations in which they owned stock. *Id.* at 785. Had they learned the identities of the officers, there is no basis for believing they could have forced the corporation to maintain corporate records or make them available. Shareholders do not control the entity as do the partners in a partnership. Shareholders can only request; they cannot compel the corporation to take or to refrain from taking action, including maintenance of corporate records.

Respondent seeks comfort in the broadly stated maxim that statutes of limitation should be applied narrowly against the government. Br. Resp. 8 n.5; *cf. Badaracco v. Commissioner*, 464 U.S. 386, 391-92 (1983). That maxim appears to have originated in rather old conceptions of the doctrine of

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[52] One of the taxpayers in the *Green* case.

sovereign immunity. *Cf. United States v. Whited & Wheless, Limited,* 246 U.S. 552 (1918). The only apparent recent occasion in which this court has cited the maxim is in *Badaracco,* a case that involved the special extended limitations period applicable to taxpayer fraud, a problem that is not involved in this case. Even if the maxim continues to have some general vitality, it should not be applied here to permit the government to negate the concept of finality and defeat the most natural reading of the statute.

In any event, if ancient maxims are to figure in this litigation, it should not be forgotten that "statutes of limitation are founded on sound policy. They are statutes of repose, and should not be evaded by a forced construction." *Pillow v. Roberts,* 54 U.S. (13 How.) 472, 477 (1851); *see generally* Douglas A. Kahn, *The Supreme Court's Misconstruction of a Procedural Statute – A Critique of the Court's Decision in Badaracco,* 82 Mich. L. Rev. 461, 475-76 (1983). In this case, the Second Circuit's reading of the statute plainly constitutes a "forced construction" incompatible with the statute's plain meaning. Moreover, the unfairness, uncertainty, and lack of finality that result from the Second Circuit's view are easily avoided with no prejudice to the Service. The Service has frequently obtained separate extensions of the statute of limitations from C corporations and their shareholders. There is no reason why the Service should not follow the same procedures for extensions from S corporations and their shareholders.

In fact, in this case, the Service sought and received an extension from the S corporation for the tax year ending November 30, 1980, as well as from Petitioner. In *Kelley,* where the facts are nearly identical to this case, the Service obtained extensions from both corporation and shareholder, 877 F.2d at 757. *See also, Jacobsson v. Commissioner,* 54 T.C.M. (CCH) 1043 (1987). The court in *Kelley* notes:

> [T]he Service can obtain an extension of the statute of limitations if it determines that it needs more time to determine the accuracy of the corporate return. A requirement that the Service obtain an extension of the statute of limitations from the S corporation serves to place the corporation on notice that it should retain the materials necessary to substantiate its return. *Kelley,* 877 F.2d at 758.

By seeking separate extensions from the S corporation and its shareholders in this and other cases, the Service has clearly demonstrated its understanding of the need for them. There is no reason to protect the Service from its own failure to secure in this case a corporate-level extension for the right corporate tax year, particularly when to do so is inequitable to the shareholder. The Service's failure should estop it from attempting to correct an omission by focusing on a different taxpayer.

Such estoppel will provide for consistency and allow taxpayers to rely on appropriate Service procedures in auditing S corporation returns. Judge Oakes pointed out in his concurring opinion in *Ogiony v. Commissioner,* 617 F.2d 14 (2d Cir. 1980), "[C]onsistency over time and uniformity of treatment among taxpayers are proper benchmarks from which to judge IRS actions." 617 F.2d at 18. *See also Sirbo Holding, Inc. v. Commissioner,* 476 F.2d 981, 987 (2d Cir. 1973).

Because the Service can easily obtain an extension, as it demonstrated in this case and in *Kelley* and *Jacobsson,* preventing the Service from making an adjustment to an S corporation's income tax return after the corporation's limitation's period has run will not prejudice or unduly burden the Service.

This Court stated in *Rothensies v. Electric Storage Battery Co.*:

> As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayers and losses to the revenues may be pointed out. . . . They tempt the equity-minded judge to seek ways for relief in individual cases. 329 U.S. 296, 302 (1946) (footnote omitted).

In this case, equity weighs in favor of the taxpayer and this Court may implement that result without undermining the statute of limitations in tax matters.

CONCLUSION

For the foregoing reasons, the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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